LIBRARY
SUPREME COURT. U. S.

FILED
MAR 4 1958
JOHN T. FEY, Clerk

Supreme Court of the United States

OCTOBER TERM, 1957

No. 830

CAPITOL COAL CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

NATHAN FRANKEL
521 Fifth Avenue
New York 17, N. Y.
Attorney for Petitioner.

HARRY JANIN,
JOSEPH H. CROWN,
Of Counsel.

INDEX

	PAGE
Opinions Below	1
Grounds of Jurisdiction	2
Question Presented	2
Statute and Regulations Involved	2
Statement of the Case	5
Reasons for Granting the Writ	8
Conclusion	13
Appendix A—Opinion of the Court Below	15
Appendix B—Judgment of the Court Below	20
Appendix C—Opinion of the Tax Court	21
Appendix D—Decision of the Tax Court	45

Citations

CASES:

Quincy Mining Company v. United States, 156 F. Supp. 913 (Ct. Cl. 1957)	8, 10
Tuttle v. United States, 101 F. Supp. 532 (Ct. Cl. 1951)	12

IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No.

CAPITOL COAL CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit, entered December 6, 1957, affirming a decision of the Tax Court of the United States, rendered on November 28, 1956. The opinion of the United States Court of Appeals for the Second Circuit, printed as Appendix "A" to this petition, is reported at 250 F. 2d 361. The judgment of the United States Court of Appeals for the Second Circuit is printed as Appendix "B" to this petition. The opinion of the Tax Court of the United States, in which the action was originally brought, is printed as Appendix "C" hereto. It is reported in 26 T.C. 1183. The decision of the Tax Court is printed as Appendix "D" hereto.

Grounds of Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on December 6, 1957. No petition for rehearing was filed. Jurisdiction of this Court is invoked under Title 28 of the United States Code, Section 1254(1).

Question Presented

Is the tax benefit rule as codified in Section 22(b)(12) of the Internal Revenue Code of 1939 and the regulations issued thereunder and as expanded by *Dobson* v. *Commissioner*, 320 U.S. 489 (1943), applicable to income resulting from cancellation of indebtedness for merchandise purchased where the deduction for all but $2.03 of such purchases in an earlier year gave rise to no tax benefit since without it there would have been no income to tax?

Statutes and Regulations Involved

The text of Section 22(b)(12) of the Internal Revenue Code[1] (26 U.S.C. (1946 ed.) Section 22(b)(12)) reads:

SEC. 22. GROSS INCOME.

* * *

(b) Exclusions From Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * *

(12) Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.—Income attributable to the recovery

[1] All references to a statutory provision are to the Internal Revenue Code of 1939, unless otherwise expressly specified.

during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of bad debt.—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of prior tax.—The term "prior tax" means a tax of account on which a deduction or credit was allowed for a prior taxable year.

(C) Definition of delinquency amount.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) Definition of recovery exclusion.—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

• • •

Regulation 111, the Income Tax Regulations under the Internal Revenue Code of 1939, in relevant part, provided as follows:

Reg. 111, §29.22 (b) (12)-1. Recovery of certain items previously deducted. (a) *In general.* Section 22 (b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applied equally with respect to all other losses, expenditures, and accruals made on the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. See *Dobson* v. *Commissioner,* 320 U. S. 489. The term "recovery exclusion" as used in this section means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22 (b) (12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) Section 22 (b) (12) items. The term "section 22 (b) (12) items" as used in this section means those bad debts, prior taxes, delinquency amounts and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22 (b) (12) item. Bad debts, prior taxes and delinquency amounts are defined in section 22 (b) (12) (A) (B), and (C), respectively. A typical example of a delinquency amount described in that section is interest upon delinquent taxes. A typical example of the other items not expressly referred to in section 22 (b) (12)

but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

• • •

Statement of the Case

The petitioner, a coal and oil dealer, purchased coal and oil from wholesalers and sold these products to the ultimate consumer and jobbers. It kept its books upon the accrual method of accounting and upon the basis of a fiscal year ending May 31.

Between July 1939 and May 1942 petitioner's financial condition was poor and during this period its creditors had full control over its business pursuant to written agreement. In May 1942 two of petitioner's creditors, to whom petitioner owed the sum of $71,490.02, agreed to accept $19,307 in full settlement of their indebtedness. During the fiscal year ended May 31, 1942, petitioner paid a third creditor $6,957.27 in full settlement of its indebtedness of $24,418.61. Immediately after the foregoing cancellations totalling $69,644.36, petitioner was solvent to the extent of $28,037.49.

The debts (aggregating $69,644.36) so cancelled in 1942 arose from the purchase of coal and oil during the fiscal year ended May 31, 1939, during which period petitioner's allowable deductions exceeded its income by $69,642.33. To the extent of $2.03—and only to that extent—the petitioner obtained a tax benefit from the inclusion of the said $69,644.36 as the cost of coal and oil so purchased. The said loss of $69,642.33 is reflected in the following statement of petitioner's operations covering the fiscal year ended May 31, 1939:

Net sales			$982,406.23
Material costs:			
Inventory — June 1, 1939	$ 15,641.28		
Coal and oil purchases, freight, towing, boating, insurance, etc.	805,298.07		
	$820,939.35		
Less inventory — May 31, 1939	9,169.44	$811,769.91	
Yard costs:			
Labor	$ 12,539.08		
Rent	5,499.96		
Repairs	1,459.37		
Light and power	782.74		
Depreciation	10,667.72	30,948.87	
Delivery costs:			
Trucking	$ 73,702.32		
Hoisting labor	920.07		
Insurance	5,957.56		
Sundry shipping costs	5,248.50	85,828.45	
Selling costs:			
Salaries and commissions	$ 30,905.57		
Officers' salaries	12,000.00		
Salesmen's expenses	13,014.66		
Advertising	1,214.78	57,135.01	
Total			985,682.24
Balance — deficiency			$(3,276.01)
General and administrative expenses:			
Officers' salaries		$ 12,000.00	
Bad debts		5,125.74	
Interest		14,430.57	
Taxes		4,682.68	
Other deductions, salaries, etc.		39,740.91	75,979.90
Total (loss)			$(79,255.91)
Other income			9,613.58
NET (LOSS) FOR YEAR			$(69,642.33)

The Commissioner determined that the petitioner realized taxable income of $28,037.49 arising from the partial cancellation of indebtedness.

Thereafter, the petitioner duly filed a timely petition for review by the Tax Court contending that the cancellations

were gratuitous and, alternatively, that under the tax benefit rule its maximum income from the cancellations could not exceed $2.03.

The Tax Court held, with respondent, that the cancellations of indebtedness resulted in taxable income to the petitioner.

The Tax Court refused to apply the tax benefit rule in this case because, it said, the petitioner had not shown that the coal and oil purchased, which gave rise to the cancelled indebtedness, was sold at a loss, adding:

> "We cannot find any interrelationship here between any losses incurred by the petitioner in the purchase and sale of coal and oil in the fiscal year 1939 and the cancellation of indebtedness amounting to $69,644.36 in the fiscal year 1942. As we have pointed out, petitioner's net sales in the fiscal year 1939 amounted to $982,406.23 and its cost of goods sold (including coal and oil purchases, freight, towing, boating, and insurance) was $811,769.91. There is no *res* which we can pick out of the sales in the fiscal year 1939 and trace it to the gain resulting from the cancellation of indebtedness in the years here involved. All that appears in the record is a lump sum showing total sales from all of petitioner's operations in the fiscal year 1939. These resulted in a gross profit and it is conceivable that the net losses which were suffered by petitioner in that year were a consequence of sale not connected at all with the products purchased by petitioner from George E. Warren Corporation, L. F. Kaine & Co., and Cities Service Oil Company which are the three creditors involved in the indebtedness cancellations. It must be remembered that petitioner purchased its supplies from various suppliers other than the ones just mentioned. We are unable to find a common denominator between any item sold by the petitioner at

a loss in the earlier year and then involved in a gain in the subsequent year. We conclude that the facts of this case do not bring it within the tax benefit doctrine as expanded by *Dobson* v. *Commissioner, supra.*" (R. 30-A; App. pp. 43-44)

The petitioner duly filed a petition for a review of the decision of the Tax Court by the Court of Appeals for the Second Circuit. The Court of Appeals for the Second Circuit affirmed the Tax Court's decision. In holding that the tax benefit rule was not here applicable, the Court of Appeals stated:

"* * * Where the recovery can be definitely related to the loss the courts have permitted a taxpayer to have a tax benefit but here there is no such fact prerequisite. In 1939 Capitol's net sales were $982,406.23 and its cost of goods sold was $811,769.91 including in addition to purchases of coal and oil such items as freight, towing, boating and insurance. At best the taxpayer has shown that purchases were made in 1939 but it has not related the alleged 1942 recovery to the 1939 losses. * * *" (R. 61-A; App. pp. 18-19)

Reasons for Granting the Writ

The decision below, insofar as it decides the applicability of the tax benefit rule, is in conflict with the decision of the United States Court of Claims in *Quincy Mining Company* v. *United States,* 156 F. Supp. 913 (Ct. Cl. 1957).

In deciding that the tax benefit rule was not applicable in this case, the Courts below grafted a tracing requirement onto the statute and regulations and the necessity of establishing that losses resulted from particular transactions. This theory was rejected in the *Quincy* case which refused so to narrow the application of the statute.

The plaintiff (and its predecessors) in the *Quincy* case were engaged in the business of (a) mining copper ore; (b) stamping and grinding the ore; (c) extracting copper concentrate from the ore; (d) melting these concentrates to produce copper; and (e) selling the copper in the market. After the copper concentrates had been extracted from the ore (the third operation mentioned), the remaining ore, known as sands, was not reprocessed, even though the sands were known to contain a considerable amount of copper; no process was then known by which the copper content could be recovered profitably.

The findings of fact in the *Quincy* case show that the plaintiff at no time made any entry upon its books or accounting records to allocate part of its costs of mining, milling and extraction of copper to the costs of the sands (the mining and milling operations were performed upon the sands, but smelting and delivery costs were obviously not applicable to the sands). All costs (mining, milling, smelting and delivery costs) incurred each year were charged against the copper that was extracted and sold during such year. The findings of fact show that for the years 1920 and 1921 the receipts from minerals produced and sold exceeded the mining and milling costs, but such receipts were insufficient to absorb the smelting and delivery costs, as shown in the following tabulation (Paragraph 12 of Findings of Fact in *Quincy* case):

	Year	
	1920	1921
Receipts	$3,210,112.65	$2,288,738.93
Mining and milling costs	3,002,350.70	2,114,779.79
Margin	$ 207,761.95	$ 173,959.14
Smelting and delivery costs	383,479.92	265,920.92
Deficiency	$ 175,717.97	$ 91,961.78

The development of new processes enabled plaintiff to retrieve a substantial part of the copper from the sands which was sold in 1947 and 1948. The sands reprocessed in 1947 and 1948 had been deposited in the lake in 1920 and 1921 (as stipulated by the parties).

The plaintiff contended that the income realized in 1947 and 1948 from the sales of copper derived from the reprocessing of the sands should be offset by a part of the original mining and milling costs incurred in 1920 and 1921 to the extent that such costs had produced no prior tax benefit. In sustaining this contention, the Court of Claims said:

> "We have, then, a case where the plaintiff in 1947 gets money for selling copper recovered from sands produced by a mining, stamping, grinding and milling process in 1920. The money which it received in 1947 was, in part, attributable to the expense which had been incurred in 1920. Some of that expense had never had any tax consequences, since, even without it, there was no income to tax. We think it was, in fact, a part of the cost of the copper sold in 1947 and that the Government has presented no valid reason why it should not be so treated for income tax purposes." (156 F. Supp. at 916)

Since the receipts from sales of copper in 1920 and 1921 exceeded the mining and milling costs, it would appear that substantially all, if not all, the copper was sold at a profit above such costs. On the other hand the fact that the gross margin was not sufficient to cover smelting and delivery costs did not necessarily mean that each pound of copper was sold at a loss; fluctuations in price throughout the year may have resulted in some sales at a profit and others at a loss. The facts stipulated in the case showed an overall loss for the year without any indication whether there were sales at a profit as well as sales at a loss. It was

the overall loss for the year which was decisive and determinative; there is not the slightest intimation that losses must be traced to particular sales.

The theory underlying the decision in the *Quincy* case is irreconcilable with the theory underlying the decision of the Second Circuit and Tax Court in the instant case. In the *Quincy* case the Court of Claims viewed the operations for the earlier year as a whole. In determining whether the amount of the cost had any tax consequence, the test it applied was whether "* * *without it, there was no income to tax* * * *". This test was rejected in the instant case. The test established in the *Quincy* case is a correct statement of the law as prescribed in Section 22(b)(12) and the regulations issued thereunder. This test, if applied to the facts in the case at bar, should have resulted in a determination that petitioner derived no tax benefit from the debt cancellations except to the extent of $2.03.

In the *Quincy* case, the Court of Claims offset the mining and milling costs (attributable to the sands) incurred in the earlier years against the income realized from their extraction in a subsequent year without requiring the establishment of a loss traceable to the mining and milling costs relating to the sands.[2] In contrast, in the instant case it was deemed indispensable that a loss traceable to the particular sales of the coal and oil purchased from the particular creditors which cancelled part of their claims be established.

In the *Quincy* case, the application of the tax benefit rule was not conditioned upon a finding that the mining and milling costs incurred with respect to particular sands had not been recovered through sales of the copper (originally extracted) at a profit over all costs. In the instant case,

2. The findings of fact in the *Quincy* case negative any such loss, for the receipts for each of the years 1920 and 1921 exceeded the aggregate mining and milling costs.

the fact that the cost of goods sold was less than the amount of receipts was considered a bar to the application of the tax benefit rule, notwithstanding the fact that petitioner sustained an overall loss in the year in question.

The *Quincy* case proceeds on the premise that there is no tracing requirement in Section 22(b)(12); the instant case proceeds on a contrary premise. The injection of such a requirement by the Tax Court and the Court below in the instant case is an unwarranted judicial gloss upon the statute and produces a conflict between *Quincy Mining* and this case. In its actual operation, the statute requires a recomputation of the prior year's operations excluding the amount recovered in the subsequent year. The recoupment is taxable only to the extent that it results in an increase in tax for the prior year. As was said in *Tuttle* v. *United States*, 101 F. Supp. 532, 535 (Ct. Cl. 1951):

> "The plaintiff relies upon the 'tax benefit' doctrine as stated in Section 22(b)(12)(D) of the Internal Revenue Code, inserted by the Revenue Act of 1942, 26 U.S.C.A. §22(b)(12)(D). *That section says that recovery of bad debts, prior taxes, and delinquency amounts should be excluded from gross income to the extent to which the deductions allowed on such transactions had not resulted in a reduction of the taxpayer's income tax.* The Supreme Court of the United States, in Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248, held that such a doctrine had been extant before the 1942 congressional enactment, and that the statute did not restrict its application to only the three kinds of losses named in the statute. Following the Dobson decision, on May 10, 1945, the Commissioner of Internal Revenue issued T.D. 5454 which expressly extended the applicability of the tax benefit doctrine of the statute to 'all other losses, expenditures * * * made the basis of deductions from gross income for

prior taxable years' with certain exceptions not here relevant. The legal force of this Treasury Decision is not contested by the Government." (emphasis ours)

In the *Tuttle* and *Quincy* cases, the Court of Claims riveted its attention on the overall loss for the particular year and exacted no tracing requirements. Its theory of the operation of the tax benefit rule, which we submit is a sound view of the law, is at complete odds with the theory adopted by the Courts in the case at bar.

Towards the end of achieving uniformity in the administration of the Federal income tax laws, this Court should assume jurisdiction and settle the principle of law involved in this case.

Conclusion

Petitioner prays that a Writ of Certiorari issue to the United States Court of Appeals for the Second Circuit to review its judgment.

Respectfully submitted,

NATHAN FRANKEL,
Attorney for Petitioner.

HARRY JANIN,
JOSEPH H. CROWN,
Of Counsel.

Appendix "A"

Opinion of the Court Below

MOORE, *Circuit Judge:*

The taxpayer, Capitol Coal Corporation, petitions for review of a decision of the Tax Court (26 T. C. 1183) finding deficiencies in income tax and declared value excess profits tax in the respective amounts of $13,100.27 and $3,958.96 for the fiscal year ended May 31, 1944.

The sole issue is the effect to be given to the cancellation of certain debts in May 1942 and March 1943 by four of the taxpayer's business creditors. The government contends that these cancellations constitute taxable income. The taxpayer argues that the cancellation was not the result of an effort between businessmen to make "the best settlement available" * but rather arose from a situation [w]here a creditor out of the goodness of his heart cancels gratuitously a debtor's indebtedness" (Applt.'s Br. p. 25). As an alternative argument in the event that the court is unwilling to attribute quite so much goodness to the corporate hearts of the creditors, the taxpayer contends that the income resulting from the cancellation of 1942 and 1943 should be set off against losses in 1939. Such a calculation, it argues, would produce taxable income of $2.03 under the tax benefit doctrine.

The taxpayer is a dealer in coal and oil, purchasing from wholesalers and selling to consumers and jobbers. In 1939, because of its poor financial condition, it entered into a written agreement with its principal creditors which provided in part for control by designees of the creditors on its board of directors and liquidation of existing debts at the rate of 2½% per month. However, the taxpayer was unable to meet this commitment and in May 1942, after vari-

---

* 26 T.C. 1183, 1191.

ous settlements had been made with other creditors during 1940 and 1941, it was indebted to the following creditors:

George E. Warren Corp.	$55,538.14
L. F. Kaine & Co.	15,951.88
Cities Service Oil Co.	24,418.61
Foreston Coal Co.	1,000.00

The Foreston Coal Company debt arose from a loan. The other debts arose during the period from June 1, 1938, to May 31, 1939, from sales of coal and oil made by the creditors to taxpayer.

In May 1942 George E. Warren Corporation, L. F. Kaine & Company and the taxpayer entered into an agreement whereby the taxpayer was to pay Warren and Kaine by a series of monthly notes $15,000 and $4,307 in full settlement of their respective claims of $55,538.14 and $15,591.88. During the 1942 fiscal year Cities Service Oil Co. had accepted $6,957.27 in full settlement of its claim of $24,418.61 and Foreston Coal Co. had cancelled its debt of $1,000. This $1,000 debt, unlike those owing to the creditors described above, did not result from purchases of inventory but rather from a loan by Foreston which was wholly owned by the brother and sister-in-law of Benjamin Sabsevitz, a co-owner of the stock of the taxpayer. Foreston had no direct business dealings with the taxpayer. Nor did the Commissioner contend that cancellation of this debt resulted in income.

After these settlements the book value of the taxpayer's assets was $75,943.76 against liabilities of $47,906.27. Being solvent to the extent of $28,037.49, the taxpayer reported this amount as gross "Income from cancellation of indebtedness" in its 1942 Federal income tax return. In March 1943 the George E. Warren Corporation cancelled $5,500 of the

notes given to it under the May 1942 agreement. The taxpayer did not include this amount as income but showed it as a credit to earned surplus.

In its 1944 return the taxpayer claimed a net operating loss for the fiscal year ending May 31, 1944 and included the $28,037.49 as part of an "Adjusted net operating loss carryover—1942" stating that the cancellation of indebtedness in this amount had been "incorrectly reported as income." The Commissioner disallowed the $28,037.49 deduction and added the $5,500 item as taxable income for 1943, which accounted for the deficiencies found for the fiscal year ending May 31, 1944.

The Tax Court found that the creditors negotiated the best settlement available of their claims and that there was lacking any intent, either express or implied, on their part to make a gift of the cancelled portions of the indebtedness.

There is more than sufficient evidence to sustain that finding. The transactions commenced as business dealings, namely, the sale of coal and oil. The efforts to collect their claims, through supervised management from 1937 to 1942, were conducted on a business basis. Even the settlements here in issue, according to the creditors' own testimony, were made to protect ther best business interests and to obtain the best possible deal. The fact that the negotiators on both sides were friendly is no evidence that a gift was intended. See *Spear Box Co.* v. *Commissioner*, 2 Cir. 1950, 182 F. 2d 844, 846; *Bradford* v. *Commissioner*, 6 Cir. 1956, 233 F. 2d 935, 936-937. Friendship between sellers and purchasers who have been dealing with each other for many years is scarcely an abnormal situation. Nor does the benefit received by the taxpayer from the cancellation carry any connotation of a gift. Naturally the creditors wanted to

keep Capitol in business because by so doing the reduced claims might be paid and there would exist a potential customer for coal and oil. The absence of any specific agreement to buy did not alter the possibility of future sales particularly if the friendly relationship were maintained.

Furthermore a gift, even if the representatives of the creditors had the power so to dispose of corporate assets, would be a most unusual occurrence when "made by a company engaged in operating a business for profit" (*Commissioner* v. *LoBue*, 351 U. S. 243, 246). See also *Commissioner* v. *Jacobson*, 336 U. S. 28, 51. As the testimony indicates the creditors' representatives, if called upon by their own employers to justify their actions, would have advanced sound business reasons in support of the cancellations.

The taxpayer's argument that the cancellations constituted a contribution to capital is without merit. They were not so intended. The supervisory control exercised through representation on Capitol's board of directors did not create a proprietary interest.

If not a gift, as it clearly is not, the taxpayer argues that since it had losses of $69,642.23 in 1939, from which it derived no tax benefit that the 1942 cancellation of $69,644.36 should be regarded as a recovery on account of losses, leaving only $2.03 as income. The taxpayer relies on the so-called tax benefit rule which permits exclusion from gross income of amounts recovered on losses deducted in former years which did not reduce taxes in such years. This rule, a limited exception to the well established annual accounting period principle (*Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 286-287; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 364-365) must be strictly applied. Where the recovery can be definitely related to the loss the courts have permitted a taxpayer to have a tax benefit but here

there is no such fact prerequisite. In 1939 Capitol's net sales were $962,406.23 and its cost of goods sold was $811,769.91 including in addition to purchases of coal and oil such items as freight, towing, boating and insurance. At best the taxpayer has shown that purchases were made in 1939 but it has not related the alleged 1942 recovery to the 1939 losses. Even were this court to take judicial notice, as the taxpayer requests, that business is a "complex mechanism" this assumption would not excuse the taxpayer from the necessity specifically of relating recovery to loss if it would have the benefit of the exception.

The Tax Court's decision is an accurate application of the law to the facts and it is affirmed.

Appendix "B"

Judgment of the Court Below

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 6th day of December one thousand nine hundred and fifty-seven.

Present: HON. CHARLES E. CLARK, Chief Judge
HON. LEONARD P. MOORE, Circuit Judge
HON. VINCENT L. LEIBELL, District Judge

CAPITOL COAL CORPORATION

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel. ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO

Clerk

Appendix "C"

Opinion of the Tax Court
[in the instant case]

The respondent determined deficiencies in the petitioner's income tax, declared value excess profits tax, and excess profits tax for the fiscal year ended May 31, 1944, in the respective amounts of $10,315.12, $3,958.96, and $4,777.91. The only issue is whether the respondent was correct in disallowing a net operating loss deduction claimed by the petitioner in the fiscal year ended May 31, 1944 in the amount of $29,992.14 on the ground that petitioner realized income in the fiscal years ended May 31, 1942 and May 31, 1943 in the amounts of $28,037.49 and $5,500, respectively, from the cancellation of indebtedness by certain creditors during those years. It is conceded by the respondent that the cancellation of debts by petitioner's creditors during the fiscal years ended May 31, 1940 to May 31, 1943, inclusive, in the aggregate amount of $125,702.34 may constitute contributions to petitioner's capital so that such amount may be included in the computation of the petitioner's equity invested capital under section 718 (a)(2) of the 1939 Internal Revenue Code. Petitioner does not dispute the disallowance by the respondent of bad debt deductions in the fiscal year ended May 31, 1942 in the amount of $2,034.21.

FINDINGS OF FACT

Some of the facts have been stipulated and they are hereby incorporated by this reference.

The Capitol Coal Corporation was organized in 1922 and it has its principal office in New York, New York. It filed

its Federal income tax return for the fiscal year ended May 31, 1944 with the then collector of internal revenue for the third district of New York. The Capitol Coal Corporation will hereinafter be called the petitioner.

The petitioner is a coal and oil dealer purchasing coal and oil from wholesalers and selling these products to the ultimate consumer and jobbers. From the time of the petitioner's organization in 1922 its outstanding capital stock has been owned in equal shares by Benjamin Sabsevitz, who is a director and vice president of the petitioner, and Reuben Brener, who is a director and president of the petitioner. Petitioner keeps its books upon the accrual method of accounting and upon the basis of a fiscal year ending May 31st.

In 1939 the financial condition of the petitioner was poor. It did not have sufficient working capital, payments to creditors were in arrears, and it was discounting its accounts receivable with factors. Petitioner's statement of operations covering the period June 1, 1938 to May 31, 1939 is as follows:

Net sales			$982,406.23
Material costs:			
Inventory — June 1, 1938	$ 15,641.28		
Coal and oil purchases, freight, towing, boating, insurance, etc.	805,298.07		
	$820,939.35		
Less inventory — May 31, 1939	9,169.44	$811,769.91	
Yard costs:			
Labor	$ 12,539.08		
Rent	5,499.96		
Repairs	1,459.37		
Light and power	782.74		
Depreciation	10,667.72	30,948.87	

Appendix C

Delivery costs:			
Trucking	73,702.32		
Hoisting labor	920.07		
Insurance	5,957.56		
Sundry shipping costs	5,248.50	85,828.45	
Selling costs:			
Salaries and commissions	$ 30,905.57		
Officers' salaries	12,000.00		
Salesmen's expenses	13,014.66		
Advertising	1,214.78	57,135.01	
Total			985,682.24
Balance — deficiency			$(3,276.01)
General and administrative expense:			
Officers' salaries		$ 12,000.00	
Bad debts		5,125.74	
Interest		14,430.57	
Taxes		4,682.68	
Other deductions, salaries, etc.		39,740.91	75,979.90
Total (loss)			$(79,255.91)
Other income			9,613.58
Net (Loss) for Year			$(69,642.33)

On July 31, 1939, the petitioner's total liabilities were $240,908.33 and its current assets, consisting of cash, accounts receivable and inventory, were $159,069.07. Its capital stock was $144,000 and it had a deficit of $172,739.24.

Sabsevitz and Saul Godwin, attorney for the petitioner, negotiated with creditors for an extension of time for the payment of obligations and as a result of such negotiations, Brener and Sabsevitz, on behalf of the petitioner and in

their individual capacities, entered into a written agreement with petitioner's principal creditors on July 21, 1939. The agreement was to continue for a period of five years with provision for earlier termination. The purpose of this agreement, hereinafter called the extension agreement, was stated therein as follows:

* * *

> (i) WHEREAS Capitol has assets consisting of machinery, fixtures, merchandise, stock on hand used in its business, book accounts, cash, good will, etc., which assets if properly handled or administered it is believed would yield sufficient to pay the indebtedness of Capitol, and
>
> (j) WHEREAS, it would be difficult for Capitol to realize upon said assets unless an extension of time be granted in which to pay its existing indebtedness, and unless an adequate supply of coal, coke and oil were assured to it to fulfill its normal business requirements for the term of this agreement,

* * *

Under the terms of the extension agreement the board of directors of the petitioner was increased from four to seven members with five members to consist of the designees of the creditors; Brener and Sabsevitz were to remain as officers with a fixed salary and to operate the business under the control of the new board of directors; the existing debts were to be paid at the rate of 2½ per cent per month beginning on October 10, 1939; the petitioner's stock owned by Brener and Sabsevitz was to be endorsed in blank and placed in escrow to guarantee performance of the agreement; and if the terms of the contract were breached the escrowees were to turn the stock over to the creditors' designees for liquidation of the petitioner. Under the terms of the extension agreement the petitioner was to purchase

its anthracite coal requirements from the George E. Warren Corporation and its bituminous coal requirements from L. F. Kaine & Co., on a consignment basis. The extension agreement was signed by Brener and Sabsevitz, in behalf of the petitioner and individually, the George E. Warren Corporation, L. F. Kaine & Co., and other creditors.

On July 25, 1939, the following persons, representing creditors, were elected to the petitioner's board of directors with Brener and Sabsevitz:

	Creditor
John Meyer	Transocean Coal Co.
Warren L. Kaine	L. F. Kaine & Co.
J. K. Barber	George E. Warren Corp.
Thomas J. Spellman	Cities Service Oil Co.
Edward A. Thompson	E. A. Thompson, Inc.

Harry A. Stonitsch was designated treasurer of the petitioner at a special meeting of the board of directors held on the same date.

Petitioner found it impossible to make the required 2½ per cent monthly payments to its creditors. The creditors did not take any action as a result of such failure and the business operations of the petitioner continued under the extension agreement. During the period from July 1939 to May 1942, a number of formal and informal meetings of the board of directors were held to discuss the business and financial conditions of the petitioner with the aid of accountants' reports which were periodically furnished to the directors. All of the directors were familiar with the poor financial condition of the petitioner during this period. Petitioner's balance sheets for the fiscal years ended July 31, 1939 and May 31, 1940, 1941 and 1942 were as follows:

Appendix C

	July 31, 1939	May 31, 1940	May 31, 1941	May 31, 1942
ASSETS				
Cash	$ 10,925.64	$ 734.00	$ 2,327.91	$ 2,664.13
Notes and accounts receivable	167,169.12	224,897.51	175,174.40	84,853.70
Less reserve for bad debts and allowances	23,683.20	33,630.00	35,037.46	13,459.69
	$143,485.92	$191,267.51	$140,136.94	$ 71,394.01
Inventory	$ 4,657.51	$ 19,612.41	None	None
Fixtures and equipment less reserve for depreciation	27,813.59	18,517.03	499.32	503.71
Prepaid insurance	3,194.37	3,630.18	1,157.29	1,381.88
Miscellaneous receivables	22,092.06	9,867.05	14,285.60	None
Total assets	$212,169.09	$243,628.18	$158,407.06	$ 75,943.76
LIABILITIES AND CAPITAL				
Accounts and notes payable	$231,122.42	$271,062.30	$192,294.20	$ 40,899.09
Accrued expenses, taxes, interest, etc.	9,785.91	8,012.08	4,228.54	7,007.18
Total liabilities	$240,908.33	$279,074.47	$196,522.74	$ 47,906.27
Capital stock	144,000.00	144,000.00	144,000.00	144,000.00
(Deficit)	(172,739.24)	(179,446.29)	(182,115.68)	(115,962.51)
Total liabilities less capital deficiency	$212,169.09	$243,628.18	$158,407.06	$ 75,943.76

By May 1942 only George E. Warren Corporation and L. F. Kaine & Co. were still creditors of the petitioner out of the original creditors who had signed the extension agreement in 1939. The Cities Service Oil Co., which had not executed the extension agreement, also remained a creditor of the petitioner in May 1942. The claims of the other creditors were settled prior to this date, and under such settlements the creditors canceled petitioner's debts in the amount of $29,667.65 and $19,890.33 during the tax-

able years ended May 31, 1940 and 1941, respectively. In May 1942 the petitioner was indebted to the following creditors:

	Amount
George E. Warren Corp.	$55,538.14
L. F. Kaine & Co.	15,951.88
Cities Service Oil Co.	24,418.61
Foreston Coal Co.	1,000.00

The Foreston Coal Company debt arose from a loan made to the petitioner. The other debts arose during the period from June 1, 1938 to May 31, 1939 from sales of coal and oil made by the creditors to the petitioner.

Petitioner's financial difficulties persisted, and prior to May 27, 1942, Sabsevitz and Godwin entered into discussions with J. K. Barber, representing the George E. Warren Corporation and L. F. Kaine & Co., Thomas Spellman representing the Cities Service Oil Co., and Irving Sabsevitz representing the Foreston Coal Co., with respect to the claims of these creditors against the petitioner. Barber at this time was the New York manager of the George E. Warren Corporation and his duties included the managing of the New York office, supervising the sales and deliveries of coal, and the collection of money. He was not a stockholder in the George E. Warren Corporation. The negotiations were conducted on a friendly basis. On May 27, 1942, the petitioner, Brener, Sabsevitz, George E. Warren Corporation and L. F. Kaine & Co., as principals, and Barber, Warren, Kaine, and Godwin as escrowees, entered into a written agreement with respect to the claims of the Warren Corporation and the Kaine corporation against the petitioner. Under this agreement the petitioner agreed to pay to the George E. Warren Corporation the amount of

$15,000 in full settlement of that corporation's claims against petitioner amounting to $55,538.14, and petitioner also agreed to pay to L. F. Kaine & Co. the sum of $4,307 in full settlement of that corporation's claims against the petitioner in the amount of $15,951.88. The amounts to be paid by the petitioner under the agreement were represented by a series of notes which were to be paid monthly over a period of time. The extension agreement of July 21, 1939 between petitioner and its principal creditors was canceled. Barber, Spellman and Kaine resigned as directors of the petitioner and the consignment arrangement between petitioner and the Warren and Kaine corporations was terminated. Petitioner's stock was placed in escrow to guarantee performance of the new agreement, with a provision for public sale of such stock by the escrowees in the event of default by the petitioner. This agreement was regarded by the creditors involved as the best settlement available in view of petitioner's unsound financial position at the time. Paragraph 8 of the agreement in 1942 provided, as follows:

> 8. Warren and Kaine hereby release and forever discharge Capitol and the second parties of and from any and all claims which they or either of them have as against Capitol and the second parties by reason of any matter, cause or thing whatsoever from the beginning of the world up to the date of this agreement, except
>
> (a) The monies collected and to be collected by Capitol from the accounts assigned to Warren now on the books of Capitol.
>
> (b) The sum of $15,000 to Warren to be paid as hereinabove set forth, and

(c) The sum of $4,307 to Kaine, to be paid as hereinabove set forth.

During the fiscal year ended May 31, 1942, Sabsevitz entered into negotiations with Thomas Spellman, general credit manager of the Cities Service Oil Co., for a final settlement of the claims of Cities Service against the petitioner. Spellman was cognizant of petitioner's financial difficulties and, with the approval of the treasurer of Cities Service, he agreed to accept $6,957.27 in full settlement of its claim against the petitioner in the amount of $24,418.61. There was no written agreement with Cities Service in connection with such settlement, nor were any notes issued. Spellman was motivated by the best interests of Cities Service in accepting the $6,957.27 in full settlement of the claims against the petitioner.

Sabsevitz and Godwin discussed the petitioner's indebtedness of $1,000 to the Foreston Coal Co. with Irving Sabsevitz, who, together with his wife, owned all of the stock of Foreston. Irving and Benjamin Sabsevitz were brothers. Irving was aware of the petitioner's poor financial condition during the discussions. He agreed to cancel the $1,000 debt owed to him by the petitioner, and in so doing, was motivated largely by the fact that Benjamin Sabsevitz was his brother.

Immediately after the petitioner made the settlements in full with the four creditors the actual value of the petitioner's assets was $75,943.76 and its total liabilities were $47,906.27, which left the petitioner solvent to the extent of $28,037.49. Petitioner included in gross income on its Federal income tax return for the fiscal year ended May 31, 1942 the amount of $28,037.49 as "Income from cancellation of indebtedness." On an attached schedule the petitioner

explained this item: "This corporation formerly was operated under the supervision of creditors and during the year ended May 31, 1942 certain creditors accounts were settled at a discount of $70,644.36. Since the corporation shows a net worth of $28,037.49, this amount has been reported as income."

In March 1943 the George E. Warren Corporation canceled note obligations of the petitioner in the amount of $5,500. These notes had been issued by the petitioner under the settlement agreement of May 27, 1942. The cancellation of the notes was negotiated by Benjamin Sabsevitz and Godwin on behalf of the petitioner and by Barber for the Warren Corporation. There was no written agreement in connection with this cancellation. Petitioner was still in a poor financial condition at this time. In its Federal income tax return for the fiscal year ended May 31, 1943, the petitioner did not include the amount of $5,500 in gross income but showed it as a credit to earned surplus with the notation that the "$5,500 income from cancellation of indebtedness was totalled as non-taxable in accordance with the American Dental decision."

After the debt settlements which took place in the years ended May 31, 1942 and May 31, 1943, the petitioner did not do any further business with the George E. Warren Corporation, L. F. Kaine & Co. or Cities Service Oil Co. Foreston Coal Co. was never a customer of the petitioner.

Petitioner claimed a net operating loss deduction in its Federal income tax return for the fiscal year ended May 31, 1944 computed as follows:

Appendix C

ITEM 27 — NET OPERATING LOSS DEDUCTION:		
Net loss reported for year ending May 31, 1942	$81,616.75	
Add net operating loss deduction taken	82,892.93	
Balance	$ 1,276.18	
Less cancellation of indebtedness incorrectly reported as income	28,037.49	
Adjusted net operating loss carry-over—1942		$26,761.31
Net loss reported for year ending May 31, 1943	$43,568.47	
Add net operating loss deduction taken	40,337.64	
Adjust net operating loss carry-over—1943		3,230.83
NET OPERATING LOSS DEDUCTION		$29,992.14

Respondent disallowed the net operating loss deduction and gave the following explanation in his notice of deficiency to the petitioner:

Schedule 1-A

EXPLANATION OF ADJUSTMENT

(a) Your claimed net operating loss deduction in the amount of $29,992.14, consisting of net operating loss carry-

over of $26,761.31 and $3,230.83 from the taxable years ended May 31, 1942 and 1943 respectively, is disallowed in accordance with the following:

	Years Ended	
	May 31, 1942	May 31, 1943
Net income or (loss) per return exclusive of net operating loss deduction	$1,276.18	($3,230.83)
Unallowable deductions and additional income:		
(1) Loss on Bad Debt	2,034.21	
(2) Income from cancellation of indebtedness		5,500.00
Total	$2,034.21	$5,500.00
Net income before allowance of net operating loss deduction	$3,310.39	$2,269.17

The net operating loss deductions of $26,761.31 and $3,230.83 from the taxable years ended May 31, 1942 and May 31, 1943 have now been converted into income for these years as shown in the above computation.

• • •

(2) It is held that the amount of $26,037.49 was correctly included in your return for the year ended May 31, 1942 as representing taxable income arising from partial cancellation of indebtedness to trade creditors. Consistent therewith, the amount of $5,500.00, representing additional cancellation of indebtedness by trade creditors in the year ended May 31, 1943 is held to represent taxable income.

Appendix C

OPINION

MULRONEY, *Judge:* The issue presented is whether the respondent was correct in disallowing a net operating loss deduction claimed by the petitioner for the fiscal year ended May 31, 1944 in the amount of $29,992.14 on the ground that such loss deduction is eliminated by including in the petitioner's income for the fiscal years ended May 31, 1942 and May 31, 1943 the respective amounts of $28,037.49 and $5,500 as income realized by the petitioner through the cancellation of indebtedness by creditors in those years. In the year ended May 31, 1942 creditors of the petitioner agreed to accept payment of $26,264.27 in full settlement of open account obligations in the amount of $96,908.63, which resulted in a cancellation of obligations in the amount of $70,644.36. After the debt cancellations, the petitioner was solvent in the amount of $28,037.49. In the fiscal year ended May 31, 1943, a creditor canceled a note indebtedness of the petitioner in the amount of $5,500. Respondent included these amounts, $28,037.49 and $5,500, in the petitioner's income for the respective years. There is no dispute about the correctness of these two amounts.

Petitioner argues that the debt cancellations in the years involved were a gratuitous relinquishment by the various creditors of a portion of the claims owing to them and were therefore excludible from income as gifts within the meaning of section 22 (b)(3) of the 1939 Internal Revenue Code. In the alternative, petitioner makes the argument that the obligations which were canceled arose through purchases of coal and oil in a year when petitioner's operations in the coal and oil business resulted in a profit of only $2.03 and, consequently, under the tax benefit rule, the cancellations of these obligations cannot result in taxable income to the petitioner greater than the amount of $2.03.

Petitioner is not prevented from making any of these contentions here by the fact that it treated the amount of

$28,037.49 in its return filed for the fiscal year ended May 31, 1942 as income from the cancellation of indebtedness. *Denman Tire & Rubber Co.*, 14 T.C. 706, affd. on other issues, 192 F. 2d 261.

To support its contention that the portion of the obligations canceled by the creditors in the fiscal year ended May 31, 1942 in the amount of $70,644.36 was a gift, the petitioner cites *Helvering* v. *American Dental Co.*, 318 U. S. 322. In that case the Court held that "The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute." We must view this decision, however, in the light of *Commissioner* v. *Jacobson*, 336 U. S. 28, which emphasized that the cancellation of an obligation may be regarded as a gift only if the intent to make a gift is present. *Standard Brass & Manufacturing Co.*, 20 T. C. 371, affd. 218 F. 2d 352; *Denman Tire & Rubber Co.*, *supra*. In the *Jacobson* case the Court said that the question is factual and "turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.'"

We are convinced that the creditors, other than petitioner's brother, obtained the best settlement available of their outstanding claims against the petitioner in the years here involved. There is lacking any intent, either express or implied, on the part of these creditors to make a gift of a portion of the claims to the petitioner, and we so find. The various negotiations between the said creditors and the petitioner indicate a continued effort on the part of the creditors to realize in full their claims against petitioner. Under the formal extension agreement dated July 21, 1939, the George E. Warren Corporation, L. F. Kaine & Co., and the other creditors took over the control of the petitioner's operations and undertook to recover their existing debts

in full at the rate of 2½ per cent each month beginning October 10, 1939. The Warren corporation, the Kaine company, the Cities Service Oil Co. and other creditors made up the majority of the board of directors under the extension agreement. Petitioner's stock was placed in escrow to guarantee faithful performance of the agreement. Petitioner was unable to meet the installment payments under the extension agreement, and prior to May 27, 1942 Benjamin Sabsevitz, petitioner's vice president and secretary, and Godwin, attorney for the petitioner, approached the George E. Warren Corporation, L. F. Kaine & Co., Cities Service Oil Co. and the Foreston Coal Co. to work out a reduction of petitioner's indebtedness to these creditors. Petitioner's representatives repeatedly stressed the inability of the petitioner to continue in operation unless the creditors would consent to some debt reduction, and "pleaded" for a chance to stay in business. The three creditors approached by petitioner were fully aware of petitioner's poor financial condition. Barber, who represented both the Warren and the Kaine corporations in these discussions, finally agreed to reduce the petitioner's claims. This settlement was considered by the creditors involved as "the best plan that we could possibly work out for the benefit of the creditors and for the benefit of the [petitioner]."

Under a written agreement dated May 27, 1942, the Warren corporation agreed to accept $15,000 in notes as "full settlement" of its claims against petitioner amounting to $55,538.14, and the Kaine corporation agreed to accept $4,307 in notes as "full settlement" of its claims amounting to $15,951.88. Again the petitioner's stock was placed in escrow to insure faithful performance of the contract. Spellman, representing Cities Service Oil Co., also agreed in the fiscal year ended May 31, 1942, to accept $6,957 in full settlement of its claim against the petitioner amounting

to $24,418.61. In making this settlement Spellman testified that he was protecting the best interests of Cities Service and was fulfilling his duties as general credit manager of his employer. The nature of the negotiations between the creditors and the petitioner, as well as the formal tenor of the settlement agreements themselves, indicate an effort on the part of the creditors to salvage as much as possible from a bad situation. It is unlikely that the officers of these creditor corporations would make a gift to petitioner of a portion of these obligations. See *Commissioner* v. *Jacobson*, *supra;* see also *J. C. Bradford*, 22 T. C. 1057, revd. on other grounds, 233 F. 2d 935 (C. A. 6, May 22, 1956).

Petitioner seeks to establish that the cancellations were gifts by pointing out the friendly relations existing between it and each of the three creditors who made these cancellations and by emphasizing the fact that these creditors wanted to benefit the petitioner by permitting it, through these debt cancellations, to remain in business. But the mere fact that the creditors knew that petitioner stood to benefit by these cancellations does not imply that the cancellations must be regarded as gifts. *Spear Box Co.*, 13 T. C. 238, affd. 182 F. 2d 844. Petitioner also argues that these creditors knew they could recover a large portion of their claims by forcing the petitioner to liquidate and that their unwillingness to do so indicates a gift of a portion of the obligation to the petitioner. Simply because the creditors did not force the petitioner to liquidate does not imply that these creditors did not make the best settlement possible. By making the settlements they did the creditors avoided the uncertainties and difficulties of taking steps to enforce collection from petitioner through liquidation proceedings. See *Denman Tire & Rubber Co.*, *supra*. They exercised their best judgment as to the best settlement available under all the circumstances.

Appendix C

In March 1943 the George E. Warren Corporation canceled notes due it from the petitioner in the amount of $5,500. These notes had been issued by the petitioner on May 27, 1942 under the terms of the settlement agreement of that date. Sabsevitz, representing petitioner, asked Barber for further help and "Told him that we needed a little more help to get over that brink, and he was agreeable to go along with our request and reduce the indebtedness by that amount." At another point he testified that he "pleaded" with Barber "on twenty occasions" to obtain further relief on his outstanding note obligations. Barber again reviewed petitioner's poor financial condition, discussed the matter with his employer, the Warren corporation, and then agreed to the cancellation. In doing so Barber thought "it was in the best interests" of both the Warren corporation and the petitioner to cancel the note obligation. We are convinced that the creditor again manifested no intent, either express or implied, to make a gift of this amount to petitioner but, instead, was making the best arrangement possible in view of petitioner's continued financial weakness.

The fourth creditor, Irving Sabsevitz, also agreed in that same year to cancel his claim against petitioner in the amount of $1,000. He, too, was fully aware of the petitioner's financial difficulties, and as the brother of Benjamin Sabsevitz, who was petitioner's vice president, Irving was largely motivated by personal considerations in canceling the obligation. Irving Sabsevitz testified in this case and the gist of his testimony is that the cancellation of the note was a gift. He said: "I wouldn't want to hurt him. He is my brother." We can conclude from his testimony a gift was intended but it will not change the result in this case since, as will appear later in the opinion, only $28,037.49 of the total debts canceled in the fiscal year 1942 (in the

sum of $70,644.36) is includible in petitioner's income for that year.

In all, the four creditors in the fiscal year ended May 31, 1942, canceled debts due them by the petitioner amounting to $70,644.36, and immediately after the cancellations the petitioner was solvent to the extent of $28,037.49. It is well established the gain the insolvent debtor realizes from the cancellation of debts is no more than the excess of assets over liabilities after the cancellation of indebtedness. *Lakeland Grocery Co.*, 36 B. T. A. 289; *Fashion Park, Inc.*, 21 T. C. 600. When the George E. Warren Corporation canceled petitioner's note indebtedness of $5,500 in the fiscal year ended May 31, 1943, the petitioner was solvent in an amount greater than the cancellation. We hold that the cancellations of indebtedness by the petitioner's creditors in the fiscal years ended May 31, 1942 and 1943 resulted in the realization of ordinary income to the petitioner in the amounts of $28,037.49 and $5,500, respectively.

Petitioner argues, in the alternative, that if the cancellations are not deemed gratuitous "the amount of taxable income attributable to the cancellations should be limited to $2.03 under the tax-benefit doctrine." It has been stipulated that out of a total of $70,644.36 in debts canceled in the year ended May 31, 1942, a portion of such debts, in the amount of $69,644.36, arose during the period from June 1, 1938 to May 31, 1939 from sales of coal and oil by the three creditors involved to the petitioner in that fiscal year. Petitioner's argument is that the $69,644.36 of debts canceled represented the cost of the coal and oil purchased and appeared as a part of the cost of goods sold in determining the profit or loss from petitioner's operations as a coal and oil dealer for the fiscal year ended May 31, 1939, and since those operations resulted in a loss of $69,642.33,

the petitioner contends that it derived no tax-benefit except to the extent of $2.03.

Petitioner cites *Dobson* v. *Commissioner*, 320 U. S. 489, and *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, in support of its argument. We do not believe that the principles of those cases are applicable here. In *Kerbaugh-Empire Co., supra*, the taxpayer borowed marks from a German bank prior to 1921 to finance construction work by a German subsidiary. The borrowed sums were expended by the subsidiary and were subsequently lost. The subsidiary was allowed the losses in its income tax return, and the losses so allowed were in excess of taxable income. In 1921 the German mark fell in value and on the basis of an exchange rate of 2½ cents per mark the taxpayer paid its indebtedness, which had been incurred when more dollars were required to buy the mark, to the German bank. The Commissioner determined that the taxpayer had a taxable gain in the year of the settlement, but the Supreme Court held for the taxpayer on the ground that "The result of the whole transaction was a loss."

It appears in the instant case that the petitioner made net sales of $982,406.23 in the fiscal year ended May 31, 1939 and from this amount deducted cost of goods sold in the amount of $811,769.91, resulting in a gross profit on sales in the amount of $170,636.32. From this amount the petitioner deducted selling, delivery, and yard costs, as well as general and administrative expenses, which, with a minor adjustment not pertinent here, converted the gross profit into a net loss of $69,642.33 for the fiscal year. In *Church's English Shoes, Ltd.*, 24 T. C. 56, affd. 229 F. 2d 957 (C. A. 2, 1956), where we held that the *Kerbaugh-Empire Co.* case was inapplicable, we said:

> In this case, petitioner has not shown that the merchandise which it purchased in 1935 was sold at a loss,

> if it was. Petitioner only shows that there was an operating loss sustained for all of its business for each fiscal year ending on June 30, 1936 and 1937. Such net operating losses may have been the result of unprofitable transactions other than sales of the goods bought in 1935, in question. In *Kerbaugh-Empire Co.*, the evidence established that construction work which was financed by the use of foreign exchange resulted in a loss which exceeded the gain realized upon the purchase of foreign exchange used to pay notes given to obtain financing. We do not have here a like situation in fact, and conclude that *Kerbaugh-Empire Co., supra,* does not apply to the facts of this case.

In the present case, the indebtedness of $69,644.36 canceled subsequently by the three suppliers of coal and oil represents only a small portion of the coal and oil purchased in the fiscal year 1939 and we cannot say that the coal and oil represented by this amount was sold at a loss. As in *Church's English Shoes, Ltd., supra,* the petitioner seeks to invoke the rule of *Kerbaugh-Empire* merely by showing an operating loss for all of its business in the fiscal year ended May 31, 1939. We believe the rationale of the *Church* case is applicable here. It is not shown that the coal and oil purchased in the fiscal year 1939, which gave rise to an indebtedness of $69,644.36, was sold at a loss and consequently we cannot say that losses from the purchase and sale of coal and oil supplies in the fiscal year 1939 absorbed the gain of $69,644.36 realized by the petitioner in the cancellation of indebtedness by the suppliers in the fiscal year 1942. We conclude that *Kerbaugh-Empire Co., supra,* does not apply here.

Nor do we believe that the petitioner's argument here can be supported by the tax benefit rule as expanded in

Appendix C

Dobson v. *Commissioner*, 320 U.S. 489.[1] There the taxpayer bought bank shares which he subsequently sold at a loss in 1930 and 1931. These losses were allowed in his income tax returns for those years but even if the entire amount of deductions claimed on account of these losses had been disallowed the returns of the taxpayer would still have shown net losses. In 1936 he discovered that he had been

---

[1] The tax benefit rule appears in the 1939 Internal Revenue Code as follows: SEC. 22. GROSS INCOME.

* * * * * * *

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * * * *

(12) Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax or amount. For the purposes of this paragraph:

(A) Definition of bad debt.—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * * * *

(C) Definition of delinquency amount.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) Definition of recovery exclusion.—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

induced to make the stock purchases by fraudulent representation and brought suit against the seller. In 1939 the taxpayer recovered a portion of the original cost of the stock and the Commissioner determined that this recovery, with adjustments not relevant here, constituted ordinary income. The Supreme Court held for the taxpayer and pointed out that "no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit." In *Birmingham Terminal Co.*, 17 T.C. 1011, we said:

> To be sure, section 22(b)(12) of the Internal Revenue Code, which was intended to achieve a like result in certain circumstances, is literally not applicable here, but it was made plain in *Dobson* v. *Commissioner*, 320 U.S. at 505-506, that the addition of these provisions to the Code did not preclude the application of a similar rule in other comparable cases.

Petitioner contends that this is a "comparable" case and therefore within the expanded tax-benefit doctrine. We cannot agree. In *Merton E. Farr*, 11 T. C. 552, affd. *sub nom. Sloane* v. *Commissioner*, 188 F. 2d 254, we said:

> [Dobson v. Commissioner, 320 U. S. 489] stated that no principle of law compelled the courts to find taxable income in a transaction where, as a matter of fact, it found no economic gain and no use of the transaction to gain a tax benefit. Regardless of the possible extensions of the tax benefit rule by the *Dobson* case, one certain requirement for invoking it is that there be such an interrelationship between the event which constitutes the loss and the event which constitutes the recovery that they can be considered as parts of one

and the same transaction. This point was made clear in the *Dobson* case, *supra,* on page 502, where the Court said:

> * * * Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. * * * The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that "regarding the series of transactions as a whole, it is apparent that no gain was actually realized." * * *

In all the cases cited by petitioner as authority for applying to the instant case the concept that where there is no economic gain there is no taxable income, the fact situations reveal a close integration of events producing the loss and the gain. In each instance the property on which the loss was suffered can be traced into the transaction producing the gain; the loss and the gain could be attributed to the same *res.*

We cannot find any interrelationship here between any losses incurred by the petitioner in the purchase and sale of coal and oil in the fiscal year 1939 and the cancellation of indebtedness amounting to $69,644.36 in the fiscal year 1942. As we have pointed out, petitioner's net sales in the fiscal year 1939 amounted to $982,406.23 and its cost of goods sold (including coal and oil purchases, freight, towing, boating, and insurance) was $811,769.91. There is no *res* which we can pick out of the sales in the fiscal year 1939 and trace it to the gain resulting from the cancellation of indebtedness in the years here involved. All that appears in the record is a lump sum showing total sales from all of

petitioner's operations in the fiscal year 1939. These resulted in a gross profit and it is conceivable that the net losses which were suffered by petitioner in that year were a consequence of sales not connected at all with the products purchased by petitioner from George E. Warren Corporation, L. F. Kaine & Co., and Cities Service Oil Company, which are the three creditors involved in the indebtedness cancellations. It must be remembered that petitioner purchased its supplies from various suppliers other than the ones just mentioned. We are unable to find a common denominator between any item sold by the petitioner at a loss in the earlier year and then involved in a gain in the subsequent year. We conclude that the facts of this case do not bring it within the tax benefit doctrine as expanded by *Dobson* v. *Commissioner, supra.*

Petitioner does not contend that the cancellations in the fiscal years 1942 and 1943 were really an adjustment of the purchase price of coal and oil purchased in the earlier years. See *Hirsch* v. *Commissioner,* 115 F. 2d 656. The facts of this case do not warrant an application of the price adjustment theory set forth in the *Hirsch* case.

Respondent concedes that the petitioner, in computing its equity invested capital for excess profits tax purposes in the years here involved, is entitled to include in the computation the aggregate amount of debt cancellations by its creditors.

Decision will be entered under Rule 50.

Appendix "D"

Decision of the Tax Court

[in the instant case]

Pursuant to the Findings of Fact and Opinion of the Court filed September 25, 1956, the parties herein having filed an agreed computation of tax on November 23, 1956, it is

ORDERED AND DECIDED: That there are deficiencies in income tax and declared value excess profits tax in the respective amounts of $13,100.27 and $3,958.96 for the fiscal year ended May 31, 1944, and that there is no deficiency in excess profits tax for the fiscal year ended May 31, 1944.

JOHN E. MULRONEY,
Judge.

Enter:
Entered Nov 28 1956